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LAND TAXATION REPORM IN JAPAN

Summary

Land prices in Tokyo and other major Japanese cities have more than doubled since 1986. Although factors ranging from an abundant money supply and strong demand from corporations and individuals for land to ineffective city planning and simple speculation have aggravated the situation, tax policy has come to be regarded as a main trigger of the upward spiral in land prices. Economists and tax experts contend that drastic reforms of the land taxation system not only would increase the supply and the effective use of land within cities but would be an effective prescription for other serious social and economic problems. U.S. government and industry also complain that high land prices work as a structural barrier to the Japanese market.

In response to these concerns the government's Tax Commission set up a subcommittee on land taxation in April. Two months later the group published an interim report proposing higher taxes on land, including idle or underutilized land. Business groups oppose most of the commission's ideas. Government agencies are divided. The Liberal Democratic Party, which has not floated any reform proposals, is scheduled to release a report in December.

The road to reform of the land taxation system is certain to be bumpy. After the government, the LDP and business groups forge a consensus, legislation will be submitted to the Diet next spring. The opposition parties, which control the upper house, gave warning of their response when they blasted the Tax Commission's proposals. The destiny of land taxation reform depends on the balance of power in the Diet, a new phenomenon of the 1990s.

Land Price Increases and Causes

The average price of commercial land in six major cities -- Tokyo, Osaka, Nagoya, Sapporo, Fukuoka and Sendai -- jumped 28.8 percent between March 1985 and March 1986. Increases in ensuing years came in leaps and bounds: 33.8 percent to March 1987, 41.8 percent to March 1988 and 25.1 percent to March 1989 (see Table 1). Caught up in the surge, residential and industrial land prices began climbing in the 1986-87 period and by September 1989 had swelled to levels roughly three times as high as in March 1980. The ripple effect has spread to other urban areas recently (see JEI Report No. 14B, April 6, 1990).

Table 1: Average Land Prices in Six Major Japanese Cities, 1980-89*

(1980 = 100)

End of Month	Commercial	Residential	Industrial
March 1981	108.1	110.6	106.7
March 1982	116.7	117.9	112.6
March 1983	124.6	122.5	116.7
March 1984	135.7	126.8	120.6
March 1985	153.6	133.8	125.0
March 1986	197.9	146.7	131.2
March 1987	264.7	186.3	153.6
September 1987	336.7	216.1	175.4
March 1988	375.2	229.4	183.2
September 1988	420.0	240.0	213.1
March 1989	469.5	264.5	243.7
September 1989	528.8	300.7	279.4

*Tokyo, Osaka, Nagoya, Sapporo, Fukuoka and Sendai.

Source: Japan Real Estate Institute

Although the high cost of land seems to be one of the most serious constraints facing Japan's economy, it is not, in fact, a nationwide problem. The average price of land in all the country's urban districts went up a relatively moderate 65.9 percent between 1980 and March 1989. The problem of high land prices is typically a big city problem.

At the most basic level the run-up in land prices during the second half of the 1980s was the simple result of a mismatch between supply and demand. Factors boosting the demand for land include:

- Office Space - Some analysts link the increasing demand for office space, particularly in Tokyo, with the surge in commercial land prices and, in turn, the jump in overall prices. The Bank of Japan underscored this factor in an April 1990 report that noted that Tokyo's office vacancy rate, one indicator

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of the demand for commercial space, dropped from 1.3 percent in 1981 to 0.8 percent in 1982 and has stayed around 0.2 or 0.3 percent since 1985. The September 1985 Plaza Accord on exchange rates significantly boosted the yen's value; as a result, Tokyo's status as one of the biggest international financial centers rose to that of New York and London. Foreign financial firms flocked to Tokyo to open offices. Companies involved in high technology or service industries, such as software, bioengineering, information and design, also rushed into Tokyo and were in need of office space.

• Money Supply - Other analysts zero in on the expansion of the money supply in the late 1980s to explain the surge in land prices. Kikuo Iwata, an economics professor at Sophia University, compared the relationship between the growth of the money supply and inflation-adjusted gross national product in a recent article in the weekly economic magazine Toyo Keizai. The difference between the two figures in the last half of the 1980s was far less than in the first half of the 1970s, implying that the increase in the money supply in the latter part of the 1980s was restrained given the economy's performance (see Table 2). If, however, the change in the money supply is measured by another indicator, called the Marshallian K, which is obtained by subtracting nominal GNP growth from money supply growth, the number for the 1985-88 period is much bigger than the comparable figures for earlier periods. That indicates that increases in the money supply in the late 1980s were relatively fast.

Table 2: Average Increase in Money Supply in Japan, 1970-88

Period	Money Supply*	Real GNP	Percentage Point Difference	Consumer Prices	Marshallian K**
1970-74	18.8%	6.0%	12.8	10.9%	2.1%
1975-79	12.3	4.7	7.6	7.3	1.5
1980-84	8.9	4.1	4.8	2.6	3.0
1985-88	9.7	4.4	5.3	0.9	4.2

*M2+CDs
**Growth in money supply (M2+CDs) minus growth in nominal GNP.

Source: Kikuo Iwata, Weekly Toyo Keizai, June 16, 1990.

The trend of consumer prices helps to explain the difference between the two series. In the 1970s the big gap between the growth of the money supply and real GNP led to higher prices across-the-board for goods and services. But monetary expansion in the second part of the 1980s did not produce hikes in the consumer price index, mainly because Bank of Japan policy was crafted to prevent inflation (see JEI Report No. 27A, July 13, 1990). Mr. Iwata concluded that the abundant money supply, as measured by the Marshallian K indicator, accelerated the upward spiral of land prices instead of the prices of goods and services. Interestingly, the Bank of Japan admitted in its April report that the increase in the money supply has played a role in the run-up of land prices.

• Speculation - Speculative land transactions also are regarded as factors in the price surge. Because land prices have never fallen in Japan's

modern history, individuals as well as businesses strongly believe that, regardless of what happens to the economy, whatever land they buy eventually will increase in value. This expectation has formed the common view that land is one of the best investments for any portfolio.

When commercial land prices began to rise in 1986, the increases quickly amplified the expectation of continuing gains and triggered speculative purchases. This speculation was supported by an abundant money supply and a symbiotic relationship between land and stock ownership. Land ownership gave businesses and individuals the collateral to borrow money to buy high-priced stock, which, in turn, provided the security for speculative land transactions. The April BOJ report supported this causation chain with data on the parallel trend between the growth of loans for real estate and land price increases over the last seven years.

Supply factors contributing to high land prices in Japan include:

• City Planning - In a report released this past May the National Land Agency estimated that 17,400 hectares (42,995 acres) of land in the Tokyo area are idle or underutilized. Of the total, 2,600 hectares (6,425 acres) either are farmed or not used at all. If this land were used for housing, an additional 200,000 to 500,000 apartment units could be built in the Tokyo area.

Moreover, land currently zoned for residential use is underutilized, according to estimates by the Tokyo metropolitan government. The Building Standards Law sets the occupancy rate for each apartment building or house as the ratio of living space to total land. The average maximum legal occupancy rate in metropolitan Tokyo was set at 2.43 in 1988, meaning the typical landowner could build 2,187 square feet of living space on a 900-square-foot plot. The actual average ratio was only 0.993 (40.9 percent of the maximum legal ratio), the Tokyo metropolitan government calculated. The counterpart to this figure is the large number of single-family homes and low-rise apartment buildings even in central Tokyo, where high-rise apartments would provide a better land-use option. The Ministry of Construction puts the average number of stories for commercial buildings, apartment houses and homes in the Tokyo area at 2.5.

• Taxation - Yukio Noguchi, an economics professor at Hitotsubashi University, estimated the effective rate of the country's real estate tax, the key tax for property owners, was only 0.06 percent of actual land prices in Tokyo in FY 1987. Inheritance and capital gains taxes on land transactions also are maintained at very low levels. Japan's tax code, in short, appears to provide no prod to put land on the market.

• Other Laws - The Land Lease Law and the House Lease Law play a role in the limited supply of rental housing. These similar laws, enacted in 1921, virtually prevent an owner from evicting a tenant for either economic or social reasons. Once a tenant obtains a lease for a house or an apartment he or she can expect to stay there even after the original contract expires since the House Lease Law basically forces the owner to renew the lease. Moreover, given the tenant's upper hand, rents generally remain low.

Many property owners think the two laws are too rigid. They are cited as a major reason landowners are very reluctant to build rental housing. In a mid-September 1989 article in Economist, a Japanese-language weekly magazine,

Yutaka Harada, an economist at the Economic Planning Agency, noted that these laws were amended in 1941 to enable soldiers returning from World War II to find their families easily. However, the two pieces of legislation have remained unchanged for 45 years. Mr. Harada contended that revision of the laws to allow owners to evict tenants for economic reasons is necessary to solve the problems of high housing and land prices.

Economic Results of Rising Land Prices

Rapid increases in land values have brought huge capital gains, whether realized or not, to property owners. This is said to have caused a widening gap in wealth distribution between Japan's haves and have-nots and heightened the perception of growing inequality among income levels. Mr. Noguchi of Hitotsubashi University estimated that the average price of a parcel of land in Tokyo jumped 2.5 times in the 1986-87 period. Those same years saw a 10 percent increase in wages and salaries as determined by the shunto spring wage negotiations. Even that boost was believed to be too small for anybody dependent largely on a job for income to buy a house in the Tokyo area. Although more than 64 percent of the households in the Tokyo area own a house or a condominium, future homeowners see few possibilities for buying there without either winning a lottery, speculating in the stock and bond markets, becoming the head of a major company or simply inheriting from parents.

The notion of inequality was strengthened in mid-April when the National Land Agency reported new data on the unrealized capital gains of corporations on land. NLA estimated that land owned by corporations had a market value of Y514.5 trillion ($3.4 trillion at Y150=$1.00) in 1988 compared with a book value of Y80.6 trillion ($537.3 billion). Simple arithmetic indicates that corporations enjoyed unrealized capital gains of Y433.9 trillion ($2.9 trillion) simply by holding land.

Not having to pay taxes on the unrealized capital gains earned by their land-holdings is just one advantage corporations have over individuals who inherit land and have to pay capital gains taxes, although the rates admittedly are low. The increasing market value of land held by firms helped push up their stock prices in the late 1980s. Moreover, companies used their land-holdings valued at market prices as collateral in borrowing money for other ventures, including stock market speculation.

The upward spiral in land prices also has an impact on such things as fixed government investment, the savings rate and Japan's current account imbalance. In the recently released final report on the Structural Impediments Initiative Tokyo promised to spend Y430 trillion ($2.9 trillion) for public investment over the FY 1991-FY 2000 period (see JEI Report No. 26B, July 6, 1990). Although the Ministry of Finance has not disclosed how it plans to divide spending among housing, water supplies, sewers, parks and other forms of social overhead capital, a considerable part of the total no doubt will have to be earmarked to buy land in major metropolitan areas. Thus, the impact of the 10-year public investment program on the quality of life in Japan will not be as great as the spending figure might indicate. In addition, MOF worries that outlays of the magnitude pledged could rekindle inflation, if the economy remains relatively buoyant, and that government purchases could give an extra boost to land prices.

High land prices also are regarded as affecting the U.S.-Japan trade imbalance in some ways. Many foreign companies complain that the high cost of commercial space in Tokyo keeps them from opening offices or sales subsidiaries in this preferred location. The result is lower sales of foreign goods in the lucrative Japanese market. In addition, the high price of land is a key factor in the often significant differences in consumer prices between Japan and the United States (see JEI Report No. 4A, January 26, 1990).

Another effect of rising land prices is to raise the prices of goods and services -- whether domestic or foreign -- in Japan, resulting in lower demand than otherwise and probably consumption as well (depending on the price elasticity of each product and service). Low consumption (which, in the Japanese context, translates into relatively high savings) increases the imbalance in the current account. By reducing land prices, some economists think, Japan can trim its high national savings rate and cut its current account surplus over the long term. Their reasoning is straightforward. One of the primary reasons for saving in Japan is to buy a fixed asset, such as a house or a condominium, which can be transferred to the next generation through inheritance. Therefore, this group of economists considers it possible to lower the personal savings rate by bringing down land prices, which reduces the cost of the targeted fixed asset -- a home.

Other economists suggest that a reduction in land prices would decrease rather than increase demand for land and/or housing in both the short and the medium run and, thus, boost net savings (savings minus investment). This group points to the fact that rising land prices historically have accompanied an upswing in demand for housing, while stagnant prices have corresponded with periods of recession. Therefore, it is inconclusive whether or not a drop in Japanese high land prices would decrease net savings and cut the current account surplus.

Land Taxation in Japan

Among the various taxes on land in Japan (see Table 3) those considered to have the greatest impact on the supply of land are the fixed assets, inheritance and capital gains taxes. The fixed assets tax (otherwise known as the real estate tax) is calculated by multiplying the "registered" market value of a property by a rate between 1.4 and 2.1 percent, depending on the municipal government. (The registered market value is the assessed value of the property.) Although the Ministry of Home Affairs reestimates registered market values every three years, critics point out that assessments are maintained at about 30 percent of the benchmark prices estimated by the National Land Agency. Moreover, many experts calculate that benchmark prices themselves are about 70 percent of actual land prices. That means that assessments represent only about 20 percent of actual prices.

The Home Affairs Ministry counters that the fixed assets tax should not be based on actual prices since it reflects the concept of "rents" -- in other words, the tax is a payment for the services provided to the property owner by the municipal government. For example, if transportation services were improved in a specific area, the tax on land in this area would go up by the amount of the anticipated benefit the landowner receives from better transportation services. Using this rationale, the Home Affairs Ministry thinks registered market values should be different from either benchmark prices or actual market

Table 3: Real Estate Taxes in Japan

Taxpayer	Tax	Tax Basis	Tax Rate (standard)	Jurisdiction
Registered owner	Fixed Assets Tax	Registered market value	1.4%	Municipal government
	City Planning Tax (in designated areas only)	Registered market value	0.3%	Municipal government
	Special Tax on Land-Holdings	Acquisition price	3.0% or 1.4%	Municipal government
Heir	Inheritance Tax	Market value	Progressive (10%-70%)	National government
Donee	Gift Tax	Market value	Progressive (10%-70%)	National government
Purchaser of real property	Real Property Acquisition Tax	Market value	4.0%	Prefectural government
	Special Tax on Land-Holdings	Acquisition price	3.0% or 1.4%	Municipal government
Applicant for registration	Registration and License Tax	Market value	5.0% (heir: 0.6%; donee or legatee: 2.5%)	National government (registration office)
Seller (individual)	Income Tax	Long-term	20.0%	National government
		Short-term	40.0%	National government
	Inhabitant's Tax	Long-term	6.0%	Municipal and prefectural governments
		Short-term	12.0%	Municipal and prefectural governments

Source: Ministry of Finance, Guide to Japanese Taxes 1989-90.

prices, both of which are affected by speculation and/or the misalignment of supply and demand. This consideration leads to a substantially lower tax burden for property owners than if other valuation bases were used.

The tax burden is reduced in two other ways. To protect owners of real estate smaller than 200 square meters (2,153 square feet) from the tax consequences of a rapid increase in land prices, the tax basis was reduced to one-fourth of assessments in 1974. Another adjustment has been in effect since 1964. If the assessment on any piece of residential land does not increase at least 30 percent during the Home Affairs Ministry's three-year reestimation period, the tax basis for the property will be raised only 10 percent. Increases in the tax base of 15, 20, 25 and 30 percent correspond to increases in registered market values of 50, 70, 90 and more than 90 percent, respectively.

The actual real estate tax burden on land smaller than 200 square meters that experienced a rise in assessment of less than 30 percent over three years can be calculated as follows:

1. Actual market price x 70 percent = NLA's benchmark price
2. Benchmark price x 30 percent = registered market value
3. Registered market value x 25 percent (to reflect the first adjustment measure) x 85 percent (15 percent reduction to reflect the second adjustment measure) = tax base
4. Tax base (4.5 percent of actual market price) x 2.1 percent tax rate (for example) = effective tax rate of 0.09 percent.

Mr. Iwata of Sophia University estimated that the effective rate of the fixed assets or real estate tax in FY 1989 was 0.07 percent in metropolitan Tokyo and 0.14 percent on average in Japan. That compared with effective property tax rates of 1.42 percent in New York City, 1.99 percent in Chicago and 0.66 percent in Los Angeles in 1984. He concluded that the extremely low effective rates of Japan's real estate tax are the main cause of the inadequate supply of property on the market.

The country's inheritance tax also provides special advantages for bequests of land. The tax is based on the National Tax Administration Agency's study of price changes for land abutting main roads in Japan's 47 prefectural capitals and the 516 districts where NTAA has local offices (see JEI Report No. 5B, February 2, 1990). Hitotsubashi University's Noguchi estimated that the NTAA ratings are 30 percent below NLA benchmark prices and about 50 percent of actual market prices. In addition, under a special provision in effect since FY 1989, the valuation base for the inheritance tax is reduced by half for property measuring less than 200 square meters.

Another inheritance tax break is the basic estate allowance, which equals Y40 million ($266,700) plus Y8 million ($53,300) multiplied by the number of heirs. Suppose a son inherits a house and land in central Tokyo with a market value of Y200 million ($1.3 million). NTAA values the property at Y100 million ($667,000) based on the above-mentioned criteria. Since housing prices in central Tokyo are extremely high, a Y200 million ($1.3 million) home most likely is on a lot of less than 200 square meters. Thus, the valuation basis would be decreased to Y50 million ($333,300) because of the special treatment accorded small pieces of property under the inheritance tax law. Since, as the sole heir, the son can deduct the Y48 million ($320,000) basic estate allowance

from the original tax base, his inheritance tax is calculated on the basis of Y2 million ($13,000). With a 10 percent tax rate (the rate applied for small inheritances), he will pay only Y200,000 ($1,300) in inheritance taxes on a Y200 million ($1.3 million) property in central Tokyo. The effective tax rate is 0.1 percent.

If the tax break for property measuring less than 200 square meters were eliminated, the son would pay nearly Y16.7 million ($111,000) in inheritance taxes on the property. If NTAA's rating price were increased to the actual market price after abolishing the tax break, his tax payment would jump to almost Y67.8 million ($451,700). Professor Noguchi recommended tnat inheritance taxes be raised by eliminating the tax break and increasing NTAA's rating price.

Capital gains from property transactions are taxed in two ways. Gains from selling land purchased within the past five years (short-term gains) are heavily taxed to restrain the speculative transactions that have cropped up in recent years. A tax rate of 40 percent is applied to an individual's capital gains. Corporations face an additional 30 or 20 percent tax bite, added to the normal corporate income tax rate, depending on whether the asset was held for two or five years, respectively. If the property was held for more than five years (long-term gains) and the capital gains are less than Y40 million ($266,700), the tax rate drops to 20 percent. Capital gains of more than Y40 million ($266,700) are subject to a 25 percent rate.

It is important to note that the capital gains tax is levied only when a piece of property is sold -- in other words, on realized gains. This aspect of the tax code is one of the reasons given for the limited amount of land on the market: many owners are holding on to their property because it is likely to continue to appreciate in value. If capital gains, realized or not, are calculated using market prices, the corresponding tax would be similar to land-holding taxes based on actual market prices. Several experts are studying the possibilities of integrating the capital gains tax with various land-holding taxes.

Idle or underutilized land also is taxed in two ways. A special land-holding tax has been levied since 1974 on property that the local government has designated as idle or underutilized land. A 1.4 percent tax is levied on the transaction value (acquisition cost) rather than the registered market value as in the case of the real estate tax. (The fixed assets tax, however, is deductible.) The Ministry of Construction has criticized the special land-holding tax on the grounds that it has not increased the supply of land on the market or improved land usage. MOC reasons that the economic criteria used by municipal governments in designating land as idle or underutilized is ambiguous. Moreover, the effective tax rate is low relative to the real estate tax. MOC also points out that only land purchased after 1968 is subject to the special tax. However, this tax does not get the spotlight in the debate over taxation of idle or underutilized land.

A prime target in that debate is agricultural land within city confines. Current law requires that farm land within what are known as Urbanization Promotion Areas be taxed in the same manner as residential land for the real estate and the inheritance taxes. But if a farmer says he or she plans to continue to cultivate land for 10 years or more and the local government verifies that fact, the land is taxed at a rate deeply discounted from the residential

rate; only when the farmer stops cultivating the land is it taxed at the residential rate.

According to the Construction Ministry, continuously cultivated farm land accounted for 23,395 hectares (57,809 acres) or 83 percent of the agricultural land in the Tokyo area in 1988. Mr. Iwata of Sophia University estimated that farmers who win the tax break pay only one-tenth to one-thirtieth of the real estate tax paid by owners of residential land. This works out to a 0.0045 percent effective tax rate in Tokyo, the professor said. An econometric analysis he did indicated that if Kanagawa prefecture (next to metropolitan Tokyo) had abolished the tax break for farmers in 1976, land prices 10 years later would have been 28 percent lower than otherwise. Mr. Iwata concluded that there is no economic rationale for preserving agricultural land in such major metropolitan areas as Tokyo, Osaka and Nagoya. The Ministry of Construction has forecast that if 10,000 hectares (24,710 acres) of agricultural land in urban areas were used for housing, an extra 1 million homes and apartment units could be added by the year 2000.

Tax Commission's Interim Report

The land taxation subcommittee of the government's Tax Commission, which began hearings May 13, submitted an interim report June 22 (see JEI Report No. 21B, May 25, 1990). The group, which is looking into reform of the fixed assets or real estate tax, taxation of agricultural land and the inheritance tax, plans to submit a final report by the end of October. It will be taken up, in turn, by the Tax Committee of the ruling Liberal Democratic Party.

The interim report points out future directions of land taxation reform, including the possibility of:

- Strengthening the taxation of property owners. Considered as alternatives to current taxes are a new flat, relatively low tax to be imposed on all land or, if that is not possible, a new special tax applicable to land held by corporations; a stiffer tax on idle or underutilized land; a higher tax on large land-holdings; and a steeper tax on property that has appreciated rapidly in recent years.

- Taxing capital gains even if they are not realized.

- Having the national government levy a land-holding tax comparable to the real estate tax imposed by local governments.

- Increasing assessments used to calculate real estate taxes so that the tax basis corresponds more closely with actual market prices.

- Raising the tax on agricultural land inside cities for both real estate and inheritance tax purposes.

- Increasing assessments under NTAA's rating system in order to boost inheritance taxes.

- Increasing the rate of the special land-holding tax on idle or underutilized land.

• Decreasing the corporate and/or the personal income tax burden at the same time taxes on land are increased to keep the tax system revenue neutral under land taxation reform.

Conclusion

The business community has registered its opposition to most of the ideas floated by the government's land taxation group. Keidanren (Japan Federation of Economic Organizations) published a position paper on land taxation reform in mid-May. It came out against the suggested flat property tax (including the variant of a special tax on land owned by corporations) and the proposed tax on unrealized capital gains on land, both of which would hit companies as well as individuals. But Keidanren supported higher taxes on idle or underutilized land and on agricultural land. Not surprisingly, the farm bloc opposes several of the ideas outlined by the government's land taxation group.

Government agencies are divided on land taxation reform. The National Land Agency is said to be a strong advocate of the suggested flat tax on land and the proposed tax on unrealized capital gains. But the land taxation group's ideas may face opposition from the Ministry of International Trade and Industry, which frequently defends the interests of small and medium-sized companies. The Ministry of Construction is stressing higher taxation of idle or underutilized land and agricultural land. The Ministry of Home Affairs and local governments do not think it is right to increase real estate taxes in the hope that a larger amount of land will be placed on the market. The Ministry of Agriculture, Forestry and Fisheries naturally does not want drastic changes in the tax system for the agriculture sector, but it admits that something might have to be done about the tax treatment of farm land within city areas.

The LDP has given no hints about how it is leaning on land taxation reform. It is said that the ruling pary's tax reformers are emphasizing effective land use, better city planning and an overhaul of the Land Lease and the House Lease Laws rather than a drastic change in land taxation. But the opposition parties, in particular the Japan Socialist Party, contend that high taxes on the business sector's unrealized land-related capital gains is necessary. They also think it is appropriate to equalize the actual market price, the registered market value used for real estate taxes and the valuation derived from NTAA's rating system for inheritance tax calculations.

Although land taxation reform has generated heated discussions in Japan in recent months, no consensus has yet arisen. Political analysts estimate that some change in property taxes is inevitable, given public dissatisfaction, foreign complaints and economic rationales. But it remains premature to predict how and when the reforms will be accomplished.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.